

**NATIONAL CREDIT UNION ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL**

**MATERIAL LOSS REVIEW  
OF  
G.I.C. FEDERAL CREDIT UNION**

**Report #OIG-13-13  
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## ACRONYMS AND ABBREVIATIONS

AEP	Annual Examination Scheduling Program
AIRES	Automated Integrated Regulatory Examination System
AMAC	Asset Management Assistance Center
Call Reports	NCUA 5300 Call Reports
CAMEL	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.
CDs	Certificates of Deposit
CPA	Certified Public Accountant
Credit Union	G.I.C. Federal Credit Union
DOR	Document of Resolution
DSA	Division of Special Actions
DSA Director	Director, Division of Special Actions
EIC	Examiner in-Charge
FCU Act	Federal Credit Union Act
FOM	Field of Membership
FPR	Financial Performance Report
GAGAS	Generally Accepted Government Auditing Standards
G.I.C.	G.I.C. Federal Credit Union
ISIS	Integrated Station Information System
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
OIG	Office of Inspector General
PCA	Prompt Corrective Action
PCO	Problem Case Officer
RD	Regional Director (Region III)
RFE	Risk-Focused Examination
WCC	Work Classification Code

## **EXECUTIVE SUMMARY**

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP (Moss Adams) to conduct a Material Loss Review (MLR) of G.I.C. Federal Credit Union (G.I.C. or the Credit Union), a federally insured credit union. We reviewed G.I.C. to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated \$7 million loss to the National Credit Union Share Insurance Fund (NCUSIF); (2) assess NCUA's supervision of the Credit Union; and (3) provide appropriate suggestions and/or recommendations to prevent future losses.

To achieve these objectives, we analyzed NCUA examination and supervision reports, as well as related correspondence. We interviewed NCUA officials and regional staff, and reviewed NCUA guidance, including regional policies and procedures, NCUA 5300 Call Reports (Call Reports) and Financial Performance Reports (FPRs).

We determined G.I.C. Federal Credit Union failed due to overstatement of \$8.1 million in assets, primarily investments in certificates of deposit (CDs) and cash, allegedly due to fraud. According to the FPR filed just prior to the discovery of the alleged fraud, the Credit Union reported total assets of approximately \$15 million, and total liabilities of \$13 million, which Credit Union management reported were comprised entirely of member shares. Region III Officials determined the Credit Union to be insolvent and on December 13, 2012, NCUA liquidated G.I.C. FCU.

The following factors created an environment in which such overstatement could go undetected.

- Questionable Management Integrity and Performance

Senior management displayed a lack of integrity and did not manage the Credit Union in the best interest of its members. External auditors identified \$5 million in discrepancies between the December 31, 2011 investment statement provided by the Assistant Manager, and the confirmations from the investment broker. NCUA examiners and Problem Case Officers (PCOs) later determined that credit union management had overstated G.I.C.'s assets by \$8.1 million.

- Weak Supervisory Committee Oversight

The supervisory committee failed to obtain supervisory committee audits for fiscal years (FY) 2009, 2010, and 2011, as required under Part 715 of the NCUA Rules and Regulations. At the time of liquidation, all three audits were past the required due date of 120 days following fiscal year end.

- Weak Board of Directors Oversight

Although the supervisory committee is the entity charged with primary responsibility over the records of the Credit Union, the Board of Directors acts as control over the supervisory committee by providing a forum for receiving the audit report and minutes of the Committee meetings. We believe G.I.C.'s Board failed in these responsibilities as evidenced by the Board's failure to keep complete and accurate minutes or to obtain Board packets with information sufficient to execute its duties.

We concluded that these factors created an environment in which assets could be vastly overstated.

We also determined NCUA could have mitigated the loss to the NCUSIF had they been more aggressive in requiring the completion of the supervisory committee audits, confirmed account balances directly with institutions,<sup>1</sup> and addressed risks related to the failures of the supervisory committee and Board of Directors.

As a result of our review, we made two observations and four recommendations to NCUA management related to increasing compliance with audit report filing requirements and enhancing examination procedures related to evidence of account balances. See Appendix A for management's response to our recommendations.

We appreciate the effort, assistance, and cooperation NCUA management and staff provided to us during this review.

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<sup>1</sup> Current examination procedures do not require this procedure.

## **BACKGROUND**

The NCUA OIG contracted with Moss Adams to conduct an MLR for G.I.C. Federal Credit Union, as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). G.I.C. was a federally chartered credit union located in Euclid, Ohio. NCUA's Region III provided supervision over the Credit Union.

### History of G.I.C. Federal Credit Union

NCUA chartered G.I.C. Federal Credit Union in 1936. The field of membership (FOM) consisted of employees of Gould, Inc.; various divisions of Gould, Inc.; employees of Imperial Clevite, Inc; employees of Powder Metal Products Division of Imperial Clevite, Inc. and Microbe Carbide Die Company. Also included in the FOM were spouses of persons who died within the FOM, employees of the credit union, and retirees from the above employers and members of their families. According to its final Call Report, September 30, 2012, G.I.C. reported total assets of \$15.5 million and membership of approximately 3,500.

Our review of NCUA examinations during the scope period, January 2007 to December 2012, identified that the Credit Union generally received positive results, usually a CAMEL Composite rating of 2. Based on our review of examiner working papers provided by NCUA Region III and additional files provided by the NCUA's Asset Management and Assistance Center (AMAC), an external CPA firm issued reports of agreed-upon-procedures to the credit union for the periods ended June 30, 2006 and December 2007, and opinion audit reports for the fiscal year ended December 2008. Our review of examination working papers determined examiners reviewed these reports.

During the examination effective March 31, 2010, examiner working papers noted that G.I.C. management informed the examiner-in-charge (EIC) about the opinion audit for the fiscal year ended December 31, 2009. Specifically, G.I.C. management had advised the EIC that the opinion audit was almost complete and that no issues were expected. The EIC documented the lack of an audit report in the Transaction Risk section of the Examination Overview for this March 31, 2010 examination, but did not exercise an administrative remedy. During the next examination effective December 31, 2010, the EIC noted in the Examination Overview section of the working papers that the fiscal year 2010 opinion audit was underway and that the fiscal year 2009 opinion audit had not revealed any significant issues. The EIC documented in the examination working papers that he reviewed the 2009 audit report. We learned during interviews with the EIC that although he reviewed what he thought was the final 2009 audit; this report was later determined to have been a draft copy.<sup>2</sup> The EIC also explained that because he reviewed what he believed to be the final 2009 audit,

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<sup>2</sup> We learned during our review that the 2009 audit report the examiner initially reviewed may have been fictitious because examiners later determined the report had been copied numerous times to effectively "washout" the Draft markings on the report.

he deemed this sufficient because the Credit Union had a history of positive examination and audit results.

During the next examination effective June 30, 2012, the EIC determined that auditors had not issued their fiscal year 2011 audit opinion. The EIC issued a Document of Resolution (DOR) requiring G.I.C.'s supervisory committee, Board, and management to ensure completion of the audit within 45 days. The EIC provided voicemails to confirm he spoke with the auditor regarding G.I.C.'s 2011 financial statement audit. On September 18, 2012, the auditor informed the EIC they were completing the 2011 audit, but did not mention that they had not completed or issued the 2009 and 2010 financial statement audit reports. During a conversation between the EIC and auditor on October 23, 2012, the auditor told the EIC that the 2011 audit was still in process and for the first time mentioned that the 2010 audit still had an open item, but again, the auditor did not mention the status of the 2009 audit.

On November 29, 2012, the Manager of G.I.C. called the EIC to inform him that the Credit Union had placed the Assistant Manager on administrative leave on November 27, 2012. The Credit Union's external auditor contacted the EIC later the same day and informed him that they had discovered a \$5 million discrepancy between the CDs held as investments per the December 31, 2011 statement provided by the Assistant Manager, and the confirmation provided directly from the institution. By December 4, 2012, NCUA examiners had identified an overstatement in cash and investments of at least \$8.1 million, primarily in the form of funds reported as invested in brokered CDs that did not exist. Region III officials transferred the Credit Union to Special Actions on December 4, 2012. The Region III Regional Director (RD) informed the NCUA Board Chairman of this issue on December 5, 2012 and executed a Notice of Involuntary Liquidation and Revocation of Charter effective December 13, 2012.

During the period when Region III officials transferred the Credit Union to Special Actions, PCOs discovered a number of issues raising the suspicion of fraud. G.I.C. management contracted a forensic examiner to review the records of the Credit Union and AMAC continued this contract upon liquidation. The forensic examination is ongoing. NCUA's Board liquidated G.I.C. on December 13, 2012. NCUA estimates the loss to the NCUSIF at \$7 million. However, the actual cost of the failure will not be known until all assets are sold.

## NCUA Examination Process

### *Total Analysis Process*

NCUA uses a total analysis process that includes collecting, reviewing, and interpreting data; reaching conclusions; making recommendations; and developing action plans. The objectives of the total analysis process include evaluating CAMEL<sup>3</sup> components, and reviewing qualitative and quantitative measures.

NCUA uses the CAMEL Rating System for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the NCUSIF, and for identifying those institutions requiring special supervisory attention or concern. The CAMEL rating includes consideration of key ratios, supporting ratios, and trends. Generally, the examiner uses the key ratios to evaluate and appraise the credit union's overall financial condition. At the conclusion of an examination, examiners assign a CAMEL rating.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,<sup>4</sup> trend analysis,<sup>5</sup> reasonableness analysis,<sup>6</sup> variable data analysis,<sup>7</sup> and qualitative data analysis.<sup>8</sup> Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends.

Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. The NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, the NCUA requires examiners to determine whether material negative trends exist, ascertain the action needed to reverse unfavorable trends, and formulate, with credit union management, recommendations and plans to ensure implementation of these actions.

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<sup>3</sup> The acronym CAMEL derives its name from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.

<sup>4</sup> Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

<sup>5</sup> Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

<sup>6</sup> As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

<sup>7</sup> Examiners can often analyze an examination area in many different ways. NCUA's total analysis process enables examiners to look beyond the "static" balance sheet figures to assess the financial condition, quality of service, and risk potential.

<sup>8</sup> Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc., which have an important bearing on the Credit Union's current condition, and its future. Qualitative data analysis may include assessing lending policies and practices, internal controls, attitude and ability of the officials, risk measurement tools, risk management, and economic conditions.

### *Risk-Focused Examination Program*

In 2002, the NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include reviewing off-site monitoring tools and risk evaluation reports as well as on-site work. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation*. Examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up; and (b) analyzing Call Reports as well as the risks detected in the credit union's operations and in management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

- Review of quarterly Financial Performance, Risk, and Call Reports;
- Communication with credit union staff; and
- Knowledge of current events affecting the credit union.

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the Annual Examination Scheduling Program (AEP).<sup>9</sup> NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated that the Annual Program would provide more timely relevant qualitative and quantitative data to recognize any sudden turn in a credit union's performance.

### **OBJECTIVES, SCOPE, AND METHODOLOGY**

We performed this material loss review to satisfy the requirements of Section 216(j) of the FCU Act, 12 U.S.C. §1790d(j), which requires the OIG to conduct a material loss review when the NCUSIF has incurred a material loss, or when unusual circumstances exist that warrant an in-depth review of the loss.<sup>10</sup>

The objectives of the MLR were to:

1. Determine the cause(s) of the Credit Union's failure and the resulting loss to the NCUSIF;

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<sup>9</sup> The AEP requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling availability.

<sup>10</sup> The FCU Act deems a loss "material" if the loss exceeds the sum of \$25 million or an amount equal to 10 percent of the total assets of the credit union at the time in which the NCUA Board initiated assistance under Section 208 or was appointed liquidating agent.

2. Assess the NCUA’s supervision of the institution, including implementation of the Prompt Corrective Action (PCA) requirements of Section 208 of the FCU Act; and
3. Make appropriate observations and/or recommendations to prevent future losses.

To accomplish our review, we performed fieldwork at the NCUA’s Region III office in Atlanta, Georgia. The scope of this review covered the period from January 2007 through liquidation in December 2012.

To determine the cause(s) of G.I.C.’s failure and assess the adequacy of NCUA’s supervision, we:

- Completed a risk assessment, which included a review of the Examination Overviews as well as other risk considerations, including consideration of minimum scope requirements for examiners;
- Prepared a chronology and summary table of regulatory examinations, which included the examination dates, examiner, CAMEL rating, supervisory actions, and significant examiner comments;
- Reviewed exam files, including exam reports, risk assessments, examination findings, DORs, confidential sections, corrective actions, examination spreadsheet files, correspondence, analysis, and other documentation;
- Reviewed G.I.C.’s Board of Directors minutes and Board packets, as well as supervisory committee minutes provided;
- Reviewed the external reports on audits, agreed-upon procedures and member account verification, including results, findings, and responses, as provided;
- Conducted interviews with Region III and Asset Management and Assistance Center (AMAC) management and staff involved with the examination, supervision, and/or liquidation of G.I.C.;
- Downloaded Call Reports and Financial Performance Reports for the scope period and performed analysis of a number of financial indicators, including net interest margin, nonmember shares, fee income, interest income, compensation, and other elements of the balance sheet and income statement;
- Considered allegations of fraud as documented in examiner work papers, including means of misappropriation and potential warning signs;

- Developed a timeline and summary of enforcement actions taken by the NCUA from 2007 through liquidation;
- Assessed NCUA supervision and evaluated the timeliness of supervisory actions; and
- Assessed the effectiveness of G.I.C. management, and oversight by the supervisory committee and Board of Directors.

We relied upon materials provided by NCUA Region III and AMAC officials, including information and other data collected during interviews.

We used computer-processed data from NCUA's AIREs and NCUA online systems. We did not test controls over these systems; however, we relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained from these systems to support our audit conclusions.

We conducted this review from June 2013 through November 2013, in accordance with Generally Accepted Government Auditing Standards (GAGAS) and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## RESULTS IN DETAIL

We determined that G.I.C. failed due to misrepresentation by management of \$8.1 million in Credit Union assets, primarily through the misstatement of certificates of deposit held as investments and cash held on deposit. Once NCUA officials corrected the records of the Credit Union for the misstatement, they determined the Credit Union to be insolvent and liquidated it within two weeks of discovery. At the recommendation of PCOs, the G.I.C. Board of Directors hired a third party to perform a forensic examination. AMAC, in its capacity as liquidating agent as assigned by NCUA Region III per the *Notice of Involuntary Liquidation and Revocation of Charter*, has instructed the forensic examiner to continue the investigation, which is ongoing.

Other factors contributing to the failure included issues with management integrity, lack of a functioning supervisory committee, and a failure of the Board to perform its duties related to receiving audit reports.

### A. Why G.I.C. Federal Credit Union Failed

<b>Management's Actions Caused G.I.C. to Fail</b>
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We determined that management's overstatement of assets, primarily investments and cash, caused G.I.C. to fail. Highlighted below are the specific factors, which we believe allowed this misstatement to occur undetected.

#### Management Integrity and Performance Issues

We determined G.I.C. management did not conduct the business of the Credit Union in the best interest of its members. Specifically, examiners discovered assets overstated by approximately \$8.1 million, including \$6 million of investments in CDs, \$1.5 million in cash and cash equivalents, and \$600 thousand in assets reported as invested in the National Investment Fund.<sup>11</sup> Region III PCOs also noted issues with credit cards, check registers, member credit card and share draft accounts, journal entries, and other suspicious transactions.

Prior to turning the case over to Special Actions, NCUA Region III examiners discovered numerous physical items with the potential for use in forging bank statements and records. Examples included various types of paper, sticky notes with single digits in various fonts,<sup>12</sup> and high-end printers, which appeared more sophisticated than what G.I.C. management needed to conduct routine business.

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<sup>11</sup> The National Investment Fund, terminated on August 23, 2013, was a fund offered exclusively to Federal and State chartered credit unions as a Common Trust Investment organized under Regulation 9 of the Comptroller of the Currency.

<sup>12</sup> We learned from interviewees that they believed credit union management affixed the notes to monthly statements and then copied the statements in order to prepare falsified documents.

Through our review of examination working papers and later corroborated in interviews, we determined NCUA regional management and examiners agreed that the falsified statements prepared by G.I.C. management looked convincing.<sup>13</sup> Several interviewees informed us that based on information obtained after discovery of the alleged fraud, they believe it was likely the manager knew of the alleged fraud. The fact that G.I.C. was a small credit union with a single branch, one manager, an assistant manager, and several tellers, supports this assertion.

Also lending credence to the interviewees' belief, regional staff discovered some of the items mentioned above (sticky notes, glue sticks, various kinds of paper, etc.) in the manager's backpack. In addition, interviewees informed us that in November 2012, prior to examiners arriving on site for the examination effective September 30, 2012, the manager ordered the destruction of more than two tons of paper records, computer hard drives, and electronic media relating to transactions from 2011 through June 2012, while leaving records from earlier periods untouched.

#### Weak Supervisory Committee

Examiners routinely documented the supervisory committee as weak and ineffectual in the examination working papers. This is consistent with what we learned during interviews and our review of the G.I.C. Board minutes. The supervisory committee failed in its responsibility to obtain audits within 120 days as required under Part 715 of the NCUA Rules and Regulations for fiscal years 2009, 2010, and 2011.

In addition, the Credit Union's last completed audit was for the fiscal year ended December 31, 2008. Our review of this report revealed an issue date of November 20, 2009,<sup>14</sup> which exceeds the requirement to obtain a finalized audit report within 120 days of the period covered under audit, as required under NCUA Rules and Regulations Part 715.9.

We also learned during our review that when the external auditors noted discrepancies between confirmed investment balances and those provided by the Credit Union, the auditors were simultaneously performing the financial statement audits for fiscal years 2009, 2010, and 2011. All of these audits were past due per the 120-day audit requirement. Despite this, we noted no evidence to suggest that the Credit Union applied to the Region III RD for a waiver of the 120-day requirement.

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<sup>13</sup> Region III officials provided us with copies of the falsified statements and those obtained directly from third-party institutions. Based on our comparative review of both documents, we agree.

<sup>14</sup> AMAC provided the report, seized from the Credit Union's files, for this review. The RD and the Director, Division of Special Actions (DSA Director) indicated that the actual issue date for the report was September 10, 2010. Although this raises the possibility that AMAC may have obtained an altered report, we could not substantiate this.

### Weak Board of Directors Oversight

G.I.C.'s Board of Directors failed in its duties as required under NCUA Rules and Regulations. Specifically, we determined that during the scope period of our review, the Credit Union's supervisory committee only presented the 2007 and 2009 audit reports, which were met with minimal discussion. NCUA Rules and Regulations Part 715.10 requires the supervisory committee to present completed audit reports to the Board of Directors. Our review of G.I.C.'s Board minutes determined not only were these reports minimally discussed, but the 2009 audit was incomplete, which we believe not only confirms the lack of discussion, but also calls into question which report the supervisory committee presented to the Board during this meeting.

During the examination, effective December 31, 2006, examiners suggested to management that the Credit Union develop an active supervisory committee, and provided specific recommendations to the Board on how to improve the function of the committee. We noted nothing in the Board minutes to indicate that the Board followed these recommendations or took action to suspend members of the supervisory committee. In subsequent examination working papers, examiners noted an ineffective supervisory committee.

Our review of G.I.C.'s Board minutes also revealed a lack of detail and failure to include the approved Treasurer's report. We found the Board minutes to be sloppy, including a number of crossed out items and only a vague description of discussion items. We also noted that the list of investments had no total, and any attempt to reconcile the list of investments to the records of the Credit Union, as represented by the Board packets, was impossible, as the Board packets did not contain a balance sheet.

### **B. NCUA's Supervision of G.I.C. Federal Credit Union**

<b>NCUA Examiners Could Have Identified Irregularities Sooner</b>
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We determined examiners could have identified irregularities earlier had they more aggressively enforced the requirement that the supervisory committee complete an audit of the Credit Union within 120 days of fiscal year end. In addition, although examiners followed current NCUA policies and procedures to gain assurance over cash and investment balances, we determined current examination requirements do not require confirmation of significant balances directly with institutions. As a result, management was able to manipulate and falsify monthly bank statements that went undetected by examiners. Finally, we determined that examiners failed to require the G.I.C. Board and management to build a functioning supervisory committee and did not adequately address the Board's failure in their responsibilities over the records of the Credit Union. As a result, the NCUSIF incurred a loss of \$7 million. However, NCUA will not know the true cost of the failure until all assets are sold.

### Supervisory Background

G.I.C. received a CAMEL Composite rating of 2 at the conclusion of the examination effective June 30, 2012, an indication of fundamentally sound performance and consistent with previous examinations for the scope period of our review. Examiners completed the June 30, 2012 examination on October 30, 2012. On November 29, 2012, the EIC received a telephone call from the Credit Union’s manager stating that the Board had removed the assistant manager based on issues brought to their attention by the external auditors. On this same date, examiners began an examination effective September 30, 2012, and completed it on December 8, 2012. The results of this examination downgraded the Credit Union’s CAMEL Composite and all component ratings to 5. Region III’s RD executed a *Notice of Involuntary Liquidation and Revocation of Charter* effective December 13, 2012. On December 27, 2012, examiners started the final contact of G.I.C. with an effective date of November 30, 2012 and with the intent of liquidating the Credit Union. Table 1 (below) provides Composite and specific CAMEL ratings for the applicable examinations during the scope period of our review.

**Table 1**

NCUA Examination Results for G.I.C.**							
Examination Effective Date	Exam Type <sup>15</sup>	CAMEL Composite	Capital/ Net Worth	Asset Quality	Management	Earnings	Liquidity
November 2012	22	5	5	5	5	5	5
September 2012	22	5	5	5	5	5	5
June 2012	10	2	1	2	2	1	3
December 2010	10	2	1	2	2	1	3
March 2010	10	2	1	2	2	1	2
June 2009	22	2	1	1	2	1	2
March 2008	10	1	1	1	1	1	1
December 2006	10	2	1	3	2	1	2

\*\*Examination information provided by NCUA’s Region III.

### Failure to Enforce the Requirement for a Supervisory Committee Audit

Based on our review of examination working papers, we determined that during the examination effective March 31, 2010, G.I.C. management informed the EIC that the fiscal year 2009 financial statement audit was almost complete and that they expected no issues.

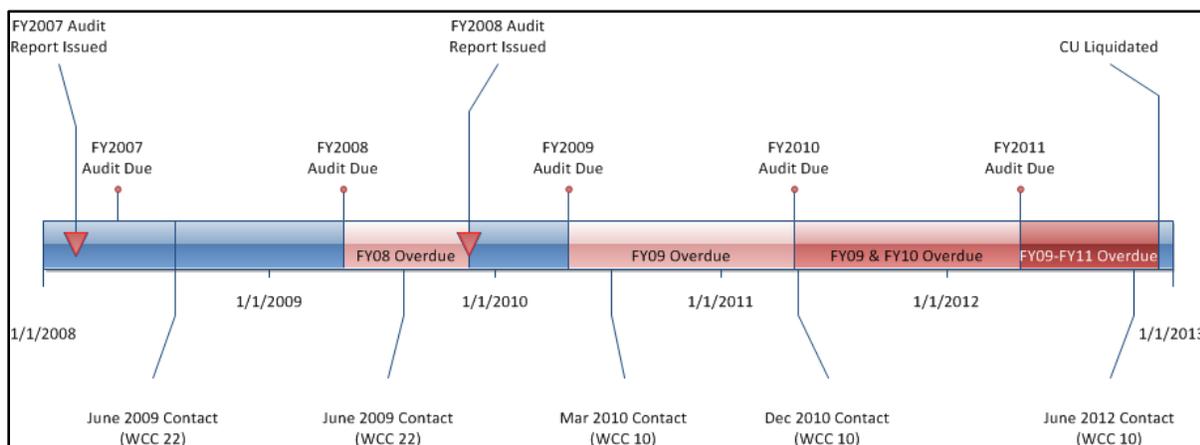
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<sup>15</sup> Work Classification Code (WCC) Examination Type 10 is a regular examination or insurance review of a federally chartered credit union and Type 22 is an on-site supervision contact of a federally chartered credit union.

The EIC documented the lack of an audit in the working papers, but did not raise this issue as a DOR item.

During subsequent contacts, G.I.C.’s external auditors informed the EIC that relevant audits were underway; leading the EIC to believe that the external auditors had completed the prior audits, when in fact they had not. This continual cycle of starting audits, but not completing them, ultimately led to three fiscal years of overdue audit opinions, which were not in compliance with the 120-day deadline in NCUA Rules and Regulations Part 715.9<sup>16</sup> Table 2 (below) provides a timeline of events for the external audit reports and NCUA examinations.

**Table 2**



Examiners did not issue a DOR related to the 120-day audit requirement until the examination effective June 30, 2012. During this contact, the EIC issued a DOR requiring the Board, supervisory committee, and manager to complete the FY 2011 audit within the next 45 days. We determined this DOR did not mention the 2009 nor the 2010 audit, which were later found to be incomplete and not issued.

We believe had the EIC issued a DOR for the overdue FY 2009 audit report during the examination effective March 31, 2010, then at a minimum, the risk-focused examination program requirements related to DOR follow-up would have required the EIC to ensure that external auditors had completed the prior audits. We also believe that this would have increased the probability that the overstatement in assets would have been discovered, assuming the external auditors performed confirmation procedures, which is the common (but not mandatory) practice.

To gain a more general understanding of risk-focused examination procedures related to audit reports, we asked interviewees whether current procedures require examiners to obtain

<sup>16</sup> Due to insufficient evidence, we could not determine why external auditors did not complete the audits.

external audit reports directly from independent accountants. Interviewees told us that current procedures do not have this requirement, and several interviewees cited time constraints and the lack of an effective method to track the status of audits in subsequent exams as the reason why they do not obtain them directly.

#### Failure to Confirm Institutional Balances

We learned during interviews and through our review of examiner working papers that examiners relied on investment statements provided to them by G.I.C. management as evidence of cash and investment balances. This is consistent with NCUA policy and we found nothing to indicate that examiners did not follow these policies.

However, we also learned during examiner interviews conducted during the course of this review that the examiners in this case assumed that because the external auditors had issued an unqualified opinion, that the auditors had properly executed confirmation over cash and investments, without exception. Although confirmation over cash and investment accounts is common practice as part of an opinion audit, there are no standards requiring auditors to perform these steps, i.e., they are not mandatory. Therefore, although an unqualified opinion provides some level of assurance over the records of the credit union, examiners should not assume that the auditor directly confirmed cash and investment balances with third party institutions, and should inquire as to what verification method the auditor used.

As previously noted, audits for calendar years 2009, 2010 and 2011 were open at the same time. It is important to note here that the external auditor could have been more proactive in informing the examiner of the status of prior audits, and why completion of the audits had been delayed.

Interviewees also informed us that if the external auditor has not issued their final audit opinion report prior to the conclusion of the examination, they often obtain the final report during the next examination. Interviewees indicated they will not review the auditors' in-process working papers or confirm balances directly. Although not a required examination procedure, we believe had examiners confirmed cash and investment balances directly with the safe keeper, examiners would have likely discovered the fictitious investments sooner.

#### Failure to Address Risk with an Ineffective Supervisory Committee

During our review of examination working papers, we determined examiners considered the supervisory committee to be ineffective. The EIC provided a number of recommendations in the Examination Overview to strengthen the supervisory committee in the examination effective December 31, 2006. Recommendations included holding more meetings, keeping minutes, using NCUA's *Supervisory Committee Guide for Federal Credit Unions*, and increasing skill and understanding through training. However, we noted no follow-up in subsequent contacts.

Supervisory committees at small credit unions present a particular challenge because the pool of volunteers is limited. However, the checks and balances envisioned in the structure of a credit union as put forth by the *NCUA Rules and Regulations* depends on the proper functioning of the Board of Directors, supervisory committee, and management. The examiners we interviewed consider independent accountants to act as a mitigating control to ineffective supervisory committees. However, we believe that if the supervisory committee is not functioning, the independent audit function operates without oversight. Such a situation is contrary to the roles specified in the *NCUA National Supervision Policy Manual* and the *NCUA Rules and Regulations*.

Starting with the examination effective December 31, 2006, we believe that examiners should have initially included recommendations as examiner findings, and escalated the administrative remedy to a DOR and taken further steps if G.I.C. management had not fully and timely complied. Without an effective supervisory committee, examiners cannot be certain that internal controls at a credit union are functioning as intended, placing member funds and the NCUSIF at risk.

#### Failure to Address Risk with an Ineffective Board of Directors

We determined examiners failed to hold G.I.C.'s Board of Directors responsible for ensuring the fidelity of the credit union's records. Although the supervisory committee is responsible for ensuring the completion of the financial statement audits, the Board of Directors also plays a role in this monitoring process by providing a forum for receipt of the supervisory committee's report on the financial statement audits. We believe had examiners taken a more aggressive approach and escalated administrative remedies to address the Board's ineffectiveness, it would have been more likely that the supervisory committee would have functioned better and external auditors and management would have been pressed to complete the audits timely. This in turn might have increased the likelihood the misstatement would have been discovered.

In addition to failing to require the Board to fulfill its duties surrounding receipt of the supervisory committee's report on the financial statement audit, we could not find adequate support for examiners' rating of the minutes as "good" or "detailed" as documented in the Examination Scope working papers.<sup>17</sup> We believe more detailed minutes and comprehensive Board packets would have increased the probability that examiners would have either detected the misstatement or at least caused the supervisory committee to complete the audits.

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<sup>17</sup> Board minutes were provided to us by AMAC from the Credit Union's records. Examination working papers are not required to include the raw minutes. It is therefore possible that our minutes differ from those reviewed by examiners.

## **OBSERVATIONS AND RECOMMENDATIONS**

### **A. Observations**

We interviewed eleven individuals during the course of this MLR. Through this process, we noted two observations that were not germane to the failure of G.I.C. but were sufficiently important to warrant reporting to NCUA management.

#### *Threshold for Mandatory Opinion Audit*

Part 715.5 of *NCUA Rules and Regulations* requires federally chartered credit unions with \$500 million or more in total assets to have a financial statement audit performed by a licensed independent auditor. Interviewees from Region III informed us that they believe this threshold is too high.

Smaller credit unions, which may, among other options, fulfill their requirements by performing a supervisory committee audit as described under *NCUA Rules and Regulations Part 715.7*, often have less sophisticated supervisory committees, Boards of Directors, and/or management. However, regulations allow the supervisory committee to perform the audit per the guidelines in NCUA's *Supervisory Committee Guide for Federal Credit Unions*.

We suggest NCUA management review recent OIG MLRs, interview regional directors, and consult with the supervisory committees, Boards of Directors, and management teams of a select group of small credit unions to investigate whether the \$500 million threshold is appropriate.

#### *Review of Audit Working Papers*

NCUA Instruction 5000.20, rev. 4, effective June 25, 2012, requires examiners to review external audit working papers unless the examiner determines sufficient justification exists to opt out of this procedure.<sup>18</sup> We learned from the interviews held with examiners working on G.I.C. that they believe they would benefit from additional training and guidance regarding which working papers to review and how to review them.

Following discovery of the alleged fraud, examiners reviewed audit working papers at the offices of the external CPA firm. Results of interviews indicated that these examiners considered the audit working papers to be of poor quality and the work to be insufficient. Interviewees told us that they believe the alleged fraud had continued for many years, including years under audit; however, the CPA firm retained files for only three years.<sup>19</sup> CPA

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<sup>18</sup> This rule came into effect after examiners completed all but the June 30, 2012 (Effective) examination for G.I.C.. Because the external auditor had not completed the 2009-2011 audits, we expect that auditor work papers would be incomplete.

<sup>19</sup> *AICPA Professional Standards*, AU-C 230, requires auditors to retain audit documentation for a minimum of five years.

working papers were not available for us to review so we could not review them. We therefore cannot make statements regarding the sufficiency of the CPA's work.

### Metric Analysis

We analyzed trends in a number of metrics gleaned from Call Reports and FPR data. Our purpose was to consider the Credit Union's reported results in light of the results of peers to determine if examiners missed red flags. Results of these procedures revealed several unusual trends, including return on average assets above that of peers even during the peak of the economic downturn, increasing loan balances that seemed to perfectly offset decreasing loan volume, and cash on hand that seemed far too low to support operations. We also reviewed other items such as partially documented CD investment portfolios.

While we noticed some unusual results in all of this evidence, we noted no anomalies that were so strong as to reveal the presence of fictitious CDs held for investment. Based on this review, we consider that without confirming the existence of the certificates directly with a third party, it would have been difficult for examiners to detect the misstatements in assets. As previously mentioned, examiners are not required to perform confirmations directly with third party institutions and therefore met minimum examination requirements over this area.

### **B. Recommendations**

Based on our review, we are making the following four recommendations.

We recommend NCUA management:

1. Reinforce documentation, communication, and follow up procedures required for incomplete or otherwise unacceptable external auditor reports to ensure appropriate visibility for follow up and escalation of administrative remedies if the issues are not resolved.

### **Management Response**

Management stated they have previously taken corrective action to address this recommendation through implementation of Chapter 5 of the National Supervision Policy Manual, which addresses audits, recordkeeping, and fraud. Management indicated the chapter defines an unacceptable audit and provides specific steps for examiners to take to address incomplete or unacceptable audits, including when to escalate the weaknesses to administrative action.

## **OIG Response**

We agree with management that Chapter 5 of the National Supervision Policy Manual addresses actions examiners are to take when confronted with incomplete or unacceptable audits, including when to escalate the weaknesses to administrative action. However, given the issues identified in this Material Loss Review, we recommend NCUA management reinforce the policies and procedures outlined in Chapter 5 of the National Supervision Policy Manual to ensure examiners document, communicate, and follow-up on incomplete or otherwise unacceptable external auditor reports.

2. Revise policies and procedures to require that examiners gain an understanding through direct communication with external auditors of procedures performed to verify account balances, specifically the cash, investments, brokered CD's, and member accounts. Examiners should document the results within the relevant examination working paper sections.

## **Management Response**

Management agreed and plans to revise NCUA policies and procedures to require direct communication with the external auditor in cases where the audit is past due or unacceptable, internal controls are weak or insufficient, or the audit firm is unknown or has limited experience working with credit unions. In all other cases, management indicated they expect examiners to contact the auditor directly unless mitigating circumstances exist that makes it reasonable for them to opt out of this procedure.

## **OIG Response**

We agree with management's planned actions.

3. Consider requiring examiners to obtain audit reports directly from independent auditors rather than receiving them from credit union management to avoid potential manipulation. NCUA could accomplish this through an e-file system for independent auditors to upload completed audits. Examples of similar systems include the Federal Audit Clearing House maintained by the U.S. Census Bureau and the Integrated Station Information System (ISIS) used by the Corporation for Public Broadcasting.

## **Management Response**

Management agreed but indicated they first plan to have the Office of Examination and Insurance work with the Office of General Counsel to evaluate its options for obtaining audit reports directly from independent auditors. At this time, management does not believe the auditor has a legal obligation to share their audit report with NCUA as a condition of share insurance, and therefore cannot compel the auditor to provide NCUA with a copy of the report directly.

### **OIG Response**

We agree with management's planned action to consult with NCUA's Office of General Counsel to evaluate its options and determine whether NCUA can legally compel an independent auditor to provide a copy of its report as a condition of share insurance. Should the Office of General Counsel render an opinion that NCUA does not have the legal authority, we suggest management pursue such authority through NCUA Board action or by seeking changes to the Federal Credit Union Act.

4. Revise examination guidelines to include a step requiring examiners to obtain independent verification of significant balances (e.g., greater than 10 percent of total assets) directly from third parties. To ensure minimal impact to examiner workload, we suggest the NCUA either develop an in-house system to accomplish this, use a third-party provider such as Confirmation.com, or create procedures to obtain statements directly from third parties. NCUA should construct the related policies and procedures so that the verification is available as of the contact start date.

### **Management Response**

Management agreed but indicated they first plan to have the Office of Examination and Insurance work with the Office of General Counsel to evaluate whether NCUA has the legal authority to obtain independent verification of accounts. Management stated that should the Office of General Counsel determination NCUA has the legal authority, they plan to have the Office of Examination and Insurance develop applicable policies and guidelines that will take into account risk, mitigating factors, and concerns.

### **OIG Response**

We agree with management's planned action to consult with the Office of General Counsel to determine whether NCUA has the legal authority to obtain independent verification of accounts.

## APPENDIX A: NCUA Management Response



National Credit Union Administration

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### SENT BY E-MAIL

**TO:** Inspector General James Hagen  
**FROM:** Executive Director Mark Treichel   
**SUBJ:** Comments on Material Loss Review of G.I.C. Federal Credit Union #1193  
**DATE:** November 25, 2013

This memorandum responds to your request for official comments on the Office of Inspector General's (OIG) draft report titled Material Loss Review (MLR) of G.I.C. Federal Credit Union #1193.

The MLR includes four recommendations which are outlined below with our response:

1. *Reinforce documentation, communication, and follow up procedures required for incomplete or otherwise unacceptable external auditor reports to ensure appropriate visibility for follow up and escalation of administrative remedies if the issues are not resolved.*

**Management Response:** We have taken corrective action in this area. The National Supervision Policy Manual (NSPM), implemented in July 2012, addresses audits, recordkeeping, and fraud in Chapter 5. The chapter defines an unacceptable audit and provides specific steps for examiners to take to address incomplete or unacceptable audits, including when to escalate the weaknesses to administrative action. The recent changes to the exam report provided new guidelines on issuing Documents of Resolution (DOR) to address concerns affecting the credit union's viability. Incomplete or unacceptable audits affect the credit union's viability.

2. *Revise policies and procedures to require that examiners gain an understanding through direct communication with external auditors of procedures performed to verify account balances, specifically the cash, investments, brokered CD's, and member accounts. Examiners should document the results within the relevant examination work paper sections.*

**Management Response:** We agree to revise our policies and procedures. The Office of Examination and Insurance (E&I) will develop policies that require direct communication with the external auditor in those cases where the audit is past due or unacceptable, where the internal controls are weak or insufficient, or where the audit firm is unknown or has limited

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experience working with credit unions. In all other cases, examiners will be expected to contact the auditor directly unless there are mitigating circumstances that make it reasonable for them to opt out of this procedure.

3. *Consider requiring examiners to obtain audit reports directly from independent auditors rather than receiving them from credit union management to avoid potential manipulation. NCUA could accomplish this through an e-file system for independent auditors to upload completed audits. Examples of similar systems include the Federal Audit Clearing House maintained by the U.S. Census Bureau (<http://census.harvester.gov>) and the Integrated Station Information System (ISIS) used by the Corporation for Public Broadcasting (<http://isis.cpg.org>).*

**Management Response:** E&I will work with the Office of General Counsel (OGC) to evaluate our options for obtaining audit reports directly. The audit report represents the result of a contract between the credit union and the audit firm. As an official record, the credit union is obligated to share it with NCUA as a condition of share insurance. However, we do not believe the auditor has the same obligation.

The independent auditor is bound by the terms of the engagement letter signed with the credit union. Under our current rules, this engagement letter must include provisions to allow NCUA access to the audit work papers. Under the current statute and rules, we have no other authority over the independent auditors and cannot compel them to provide NCUA with an audit report directly.

4. *Revise examination guidelines to include a step requiring examiners to obtain independent verification of significant balances (e.g., >10 percent of total assets) directly from third parties. To ensure minimal impact to examiner workload, we suggest the NCUA either develop an in-house system to accomplish this, use a third-party provider such as Confirmation.com, or create procedures to obtain statements directly from third parties. NCUA should construct the related policies and procedures so that the verification is available as of the contact start date.*

**Management Response:** E&I will work with OGC to determine if we have the authority to obtain independent verification of accounts. Once we have a determination, E&I will develop policies and guidelines for when and how we will require independent verification of accounts, taking into account risk, mitigating factors, and concerns.

NCUA remains committed to the continual improvement of our examination and supervision program and the staff training necessary to ensure the future safety and soundness of credit unions and the NCUSIF.

Thank you for the opportunity to comment.

cc: DED Kutchey  
DEI Fazio

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DDEI Segerson  
DRM Komyathy  
RD Yolles  
ARDO Toeppe  
ARDP Hibshman  
OIG Senior Auditor Bruns  
AMAC President Barton  
GC McKenna  
LRAO Shook

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